Remarks
by
ELLEN SEIDMAN
Director, Office of Thrift Supervision
at
New Markets for the New Millennium Conference
New York City
April 12, 1999

I'm pleased to be your keynote speaker today and also pleased that Small Business Administration Director Aida Alvarez asked the Office of Thrift Supervision and the other bank regulators to co-sponsor these very important workshops addressing the capital needs of inner cities, particularly capital and credit to fund small businesses.

But before I address those issues, I'll talk briefly about the thrift industry and what they're doing in regard to small business lending. From there, I'll address the roles of the information gap and discrimination in lending decisions affecting "New Markets" communities and, finally, where Small Business Investment Corporations (SBICs) fit in the equation.

Most of you know that the OTS is the primary federal regulator for all federal and many state-charted thrift institutions. At the end of 1998, there were 1,145 OTS-regulated thrift institutions having total assets of $817 billion.

Over three-quarters of these thrifts are community-based institutions with assets of less than $250 million. The industry is healthy, with a return on assets of 97 basis points and earnings of $7.6 billion in 1998.

If you associate the thrift industry with home lending, you've identified the industry's historic market. In fact, most of the institutions that survived the thrift crisis were traditional mortgage lenders. Today, thrifts still have almost 50 percent of their assets in home mortgages. However, as competition in the mortgage market has increased, thrifts have begun to diversify into consumer and commercial lending, with small business lending constituting about 50 percent of all commercial lending.

Thrifts and Community Development

So, what are thrifts doing in regard to community development? As previously stated, the thrift industry has an historic focus as mortgage lenders, but is now participating in every aspect of community development, including:

- mortgage lending;

- making loans to small business owners;
- investing in community-based organizations that provide training and managerial support for business owners; and
- investing in service corporations that have the ability to invest in organizations such as SBICs.

Having been granted a more flexible charter by Congress in late 1996, thrifts have diversified. Since that time, up to 20 percent of thrift assets can be in commercial loans. But any amount over 10 percent **must** be in small business loans. And of course thrifts have the option to invest the entire amount in small business loans if they choose. To what extent have thrifts utilized the expanded authority?

- At the end of 1998, more than $15.6 billion, or 1.9 percent, of thrifts' total assets were in business loans, about half to small businesses.
- This represents an increase of 34.5 percent in business lending over 1997.
- Considering the small number of thrifts and their traditional home lending orientation, these figures are not a poor performance, but there is certainly room to do more.

Thrifts do not currently own or have investments in SBICs. No doubt, this is at least in part because – in a statutory scheme that is quite detailed – there is no specific authority to make investments in small businesses or in SBICs.

We have initiated a regulatory project to address this issue. In the interim, a thrift wanting to invest in an SBIC directly, or in an SBIC or local small business through a service corporation, can file an application with OTS to engage in an activity "reasonably related to the business of financial institutions." The application will be processed on a case-by-case basis. Just recently, we approved the request by a Texas institution to create the Texas Mezzanine Fund, a consortium funded by thrifts and others to make loans to and equity investments in small businesses.

For answers to questions relating to this issue, let me refer you to either Deborah Dakin in our Chief Counsel's office or Sonja White in the Community Affairs division of OTS in Washington.

Funding 'New Markets' Groups

Enough about authority! Let's see if we can figure out why "New Markets" groups are not attracting either the lending or investment they need. And it's clear they're not. African-Americans represent 12.7 percent of the population, but own only 3.6 percent of all businesses.

The population is almost 11 percent Hispanic, but only 4.5 percent of all businesses are. And though women business owners have experienced a

209 percent increase in revenues, they continue to hit a financing brick wall with regard to access to credit and, in particular, capital in the formation and expansion of their businesses.

One possible explanation for this disparity is that financing opportunities are available, but existing and prospective businesses don't know about them. That's certainly possible – even likely – and conferences such as this are designed to bridge that part of the information gap.

But another kind of information gap is also at work: lenders and investors simply don't know what opportunities are available in these markets. By looking at "New Markets" applicants in new and non-traditional ways, decision-makers can learn that the opportunities are legion.

In the report, "The Business of Emerging Neighborhood Markets," prepared for Social Compact,[1] William M. Goodyear tells us why it makes sense for funders to look positively at small business lending and investment in low and moderate income communities. He shows that the traditional ways of analyzing data about these areas – which focuses on the negative – leads us in precisely the wrong direction.

Goodyear makes no attempt to alter the variables appropriate to any traditional business lending decision, namely, measuring risk and opportunity; when applicable, analyzing who you partner with to achieve success; and the role, if any, that government will play in creating environments that attract additional private investment and encourage success.

Refocus Views of 'New Markets'

What Goodyear does urge us to do is refocus the way we look at information about "New Markets" communities. Instead of focusing only on macro statistics like reported median income, he urges us to drill through that number and reconstitute it to tell the story of the entire local market, not an "average."

Here's an easy to understand example:

Social Compact researchers took a look at the stereotypical conclusion that low- and moderate-income neighborhoods don't have spending power sufficient to justify greater investment. They compared the median household incomes of Forest Glen, Chicago's highest income community, against that of South Shore and Little Village, both low- and moderate-income communities.

---

[1] *The Business of Emerging Neighborhood Markets"* by William M. Goodyear, Chairman, Emerging Neighborhood Markets Initiative, Social Compact ©1998, and President, Private Client Services, BankAmerica Corporation. Also see *Attracting Business Investment to Neighborhood Markets"* by Robert Weissbourd, Shorebank Corporation, for The Brookings Institution, 1775 Massachusetts Ave. N.W., Washington, DC 20036 (http://www.brookings.edu/ES/Urban/weissboard.pdf).

Not surprisingly, Forest Glen's reported household median income was more than twice that of the other two communities. But on a per acre basis, Forest Glen had about **HALF** the spending power of each of the other neighborhoods. In fact, Forest Glen had a concentrated retail spending power of $42,000, while South Shore's was $69,000. Little Village's was $85,000. So, the black low-income community's spending power is some 60 percent higher than Forest Glen's, and the Hispanic community's is more than 100 percent higher.

Beyond this revelation is another: The numbers for inner-city middle/working class neighborhoods frequently get lost as local governments emphasize poverty statistics in the quest for state and grant dollars. Lenders who look only at statistics such as families below the poverty level may miss new opportunities that those who explore the full income distribution of a neighborhood seize.

Another point Goodyear makes is that while lower-income residents typically take fewer vacations and may not go out to restaurants as often as higher-income folks do, they are willing to spend more than the average consumer on optimum cable entertainment – which can be done as a shared household expense – and they tend to subscribe more frequently to additional phone services. Further, they will regularly spend more on high-end foods for special meals to be taken at home. More missed opportunities – for businesses and for the lenders and investors who could finance them.

Another indicator of untapped market opportunity can be found in the amount of lost sales attributable to the inability of entrepreneurs to fund "non-traditional" or upscale ventures in these communities because lenders and investors don't believe that the neighborhood can support such ventures.

When statistics are taken from upscale malls, no matter how distant they may be from the lower income communities, zip-code data reveal that residents from low- and moderate-income communities constitute a significant percentage of those making purchases at every level on the merchandise scale – another missed opportunity.

Working in conjunction with the Emerging Neighborhoods Market Initiative of Social Compact, participating entities such as Bank America, Harris Bank, and Commonwealth Edison are setting the pace for the rest of us. As a result of their revised perspective, each has seen sales in low- and moderate-income neighborhoods that far outpace their expectations, and outpace sales in upper income areas as well.

So, we must develop new ways of looking at the economic potential of minority and low- and moderate-income communities.

But information is only part of the problem. While we're talking about taking a new view of funding business in "New Market" communities, we must acknowledge that discrimination – no matter how subtle -- remains a serious barrier.

Members of "New Markets" communities continue to experience rejection in finding funding at a rate much higher than an objective assessment of business prospects would predict.

Federal Reserve Board Governor Roger Ferguson has cited discrimination as a major barrier to credit. Aside from the moral imperative to stop the practice, Governor Ferguson recently pointed out that discriminatory lending practices carry real costs and serious economic consequences that inhibit economic opportunities, concluding that when discrimination is at work, viable economic activity goes unfunded and markets that should work do not. And of course this means that lenders and investors are missing potential earnings.

The Need for Equity

Let's assume we get rid of knowledge and discrimination barriers. Is there anything else stopping the renaissance of these markets? Of course…the lack of equity.

Lenders count on owners to take the first risk of their businesses. However, "New Markets" owners historically have few resources and little collateral. Therefore, there is a greater need in these markets for equity financing.

Federal Reserve Board Chairman Alan Greenspan has expressed his concern about the need to extend the traditional financing options. He says that credit is not the only answer. "Minorities must be assisted in finding sources of equity finance…Unless minorities can have access to all forms of capital…they will be denied the full benefits of our vibrant economy, in which all should be able to participate."

OTS researchers are among those who have been seeking alternatives to equity financing barriers. OTS researcher David Nickerson and Robert A. Jones of Simon Fraser University have concluded that lenders' ability to take an equity position in underlying collateral in proportion to the "loan to collateral value," as it evolves over time, would probably better incorporate the relevant contingencies than interest rates pegged to perceived risk.[2]

Their research proposes a new methodology for lenders attempting to form a deal that offers them greater assurance in their ability to get a fair return for their investment. They propose that lenders consider making the terms of the loan contingent on the value of the collateral as it evolves over time. Less formally, this solution would involve the lender taking an equity share in the asset that serves as collateral.

Now, there is something of a gap between theoretical research and legal authority. Before anyone tries this in the thrift, please talk to us.

[2] Working paper entitled *Debt Contracts, Stochastic Collateral and Credit Rationing,* April 1998.

Making New Market Opportunities Work

So, how do SBICs fit into the equation? Well, the nice part about SBICs is that they're in a wonderful position to remedy some of the problems that I've been discussing.

Venture capitalists think in ways consistent with turning the statistics inside out and on end to reveal opportunities to break barriers that "New Markets" constituencies now confront. Their flair for thinking outside the box – if that's where the money is – also mitigates against discrimination. And finally, their charter gives them the power, the tools, and the incentives to combine debt and equity financing.

In conclusion, there are people from every sector of the economy and from every racial group who are looking for money either to bring to market or to expand existing businesses of every type.

Workshops such as this give you many of the tools that you need to be part of that process.

"New Market" communities are a critically important gateway to new business opportunities. It is our hope that you will begin to explore some of those opportunities today, and keep going, as you discover that everyone can win: businesses, lenders, investors, communities and the nation.

Thank you. It's been a pleasure talking to you today.

###